

**Letter of Findings: 09-0001
Withholding Tax
For 2003**

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ISSUE

I. Nonresident Withholding Tax.

Authority: IC § 6-3-1-11; IC § 6-3-1-19; IC § 6-3-2-2.2; IC § 6-3-2-2.2(a); IC § 6-3-4-13; IC § 6-3-4-13(a)(1); Riverboat Development, Inc. v. Indiana Dept. of State Revenue, 881 N.E.2d 107 (Ind. Tax Ct. 2008); Miller Brewing Co. v. Indiana Dept. of State Revenue, 867 N.E.2d 713, 2007 WL 1667128 (Ind. Tax Ct. 2007); I.R.C. § 301; I.R.C. 316; I.R.C. § 702(b); I.R.C. § 1366(b).

Taxpayer argues that it is not subject to nonresident withholding tax requirements on the ground that Taxpayer is owned by an intervening pass-through entity.

STATEMENT OF FACTS

Taxpayer is an out-of-state entity which elected to be taxed as an S-corporation. Taxpayer is the part-owner of an Indiana limited liability company (LLC) which operates an Indiana casino. Owning the LLC is taxpayer's only business activity. In turn, Taxpayer's shareholders are primarily out-of-state residents.

Taxpayer is registered with the Department of Revenue (Department) as an agent for withholding Indiana adjusted gross income tax attributable to Taxpayer's income which flows through to the nonresident shareholders.

Taxpayer previously withheld income tax on behalf of the nonresident shareholders. However, the Department determined that Taxpayer failed to withhold sufficient tax on the income allotted *[sic]* to its nonresident shareholders. Accordingly, the Department assessed additional withholding tax based on the difference between what the Department concluded was the correct amount of tax and the lesser amount reported and paid by the Taxpayer.

Taxpayer disagreed with the Department's assessment and submitted a protest to that effect. In contrast to its previous practice, Taxpayer now maintains that it was not required to withhold any income on behalf of its shareholders on the ground that its shareholders received zero taxable Indiana income. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Nonresident Withholding Tax.

DISCUSSION

The Department determined that Taxpayer failed to withhold the correct amount of adjusted gross income tax attributable to its nonresident shareholders during 2003. The Department assessed the difference between what it determined was the correct withholding amount and the amount actually reported and paid. The Department assessed the additional withholding tax pursuant to IC § 6-3-4-13 which states as follows:

(a) Every corporation which is exempt from tax under [IC 6-3](#) pursuant to [IC 6-3-2-2.8](#)(2) shall, at the time that it pays or credits amounts to any of its nonresident shareholders as dividends or as their share of the corporation's undistributed taxable income, withhold the amount prescribed by the department. Such corporation so paying or crediting any nonresident shareholder:

(1) shall be liable to the state of Indiana for the payment of the tax required to be withheld under this section and shall not be liable to such shareholder for the amount withheld and paid over in compliance or intended compliance with this section; and

(2) when the aggregate amount due under [IC 6-3](#) and [IC 6-3.5](#) exceeds one hundred fifty dollars (\$150) per quarter, then such corporation shall make return and payment to the department quarterly, on such dates and in such manner as the department shall prescribe, of the amount of tax which, under [IC 6-3](#) and [IC 6-3.5](#), it is required to withhold.

(b) Every corporation shall, at the time of each payment made by it to the department pursuant to this section, deliver to the department a return upon such form as shall be prescribed by the department showing the total amounts paid or credited to its nonresident shareholders, the amount withheld in accordance with the provisions of this section, and such other information as the department may require.

The audit report concluded that as an S-corporation - itself exempt from income tax - Taxpayer was required to withhold tax on the income distributed to its nonresident shareholders "at the time that it pays or credits amounts to its nonresident shareholders as dividends or their share of the corporations undistributed taxable income." Having failed to meet the requirement, the Department concluded that Taxpayer became liable for the additional tax under IC § 6-3-4-13(a)(1).

Taxpayer disagrees arguing "all of [taxpayers] income or loss was derived from its membership interest in

[LLC's] interest in [Indiana riverboat]." Taxpayer concludes that it "did not conduct any business in Indiana or elsewhere, and its sole income from January 11, 2005 to date has been passive income...." In support of its position, Taxpayer cites to *Riverboat Development, Inc. v. Indiana Dept. of State Revenue*, 881 N.E.2d 107 (Ind. Tax Ct. 2008), transfer denied 898 N.E.2d 1220 (Ind. 2008). In that case, a Kentucky S-corporation which owned a membership interest in a limited liability company, which in turn owned and operated a gambling casino, challenged the Department's decision concluding that the S-corporation was subject to the withholding requirements on income it passed-through to its nonresident shareholders. *Id.* at 108. The Tax Court granted summary judgment in favor of the Kentucky S-corporation on the ground that the Kentucky S-corporation's interest in the limited liability company did not constitute "adjusted gross income derived from sources within Indiana" and was not subject to the withholding obligations provided under IC § 6-3-4-13 during 1998 through 2002 which were the years at issue. *Id.* at 111. The court held that the S-corporation's intangible membership interest led to the payment of "[r]eceipts in the form of dividends from investments" which are normally attributable to Indiana only if the taxpayer's commercial domicile is in Indiana. *Id.* (citing to IC § 6-3-2-2.2). Since Kentucky S-corporation did not have a commercial domicile in Indiana, the court found that the S-corporation's "dividends" did not constitute adjusted gross income derived from sources within Indiana. *Id.*

Taxpayer believes that the Tax Court decision in *Riverboat Development* is dispositive of the issues protested because its own facts are similar if not identical to the facts previously considered by the Tax Court. The Department must respectfully disagree that the facts, circumstances, and issues considered by the Tax Court in *Riverboat Development* are identical to or necessarily dispositive of those presently under consideration and that the Department is now precluded from reconsidering those issues. As noted in *Miller Brewing Co. v. Indiana Dept. of State Revenue*, 867 N.E.2d 713, 2007 WL 1667128 (Ind. Tax Ct. 2007), *aff'd* 903 N.E.2d 64 (Ind. 2009), "[E]ach tax year stands alone to be assessed separately" and finding that the Department was free to relitigate the specified issue so long as any such relitigation is done in good faith and not for purposes of harassment. *Miller Brewing*, 2007 WL 1667127 at *3.

The analysis of the issue begins with the source of the income in question. The Indiana LLC - which operated the Indiana casino - is and was taxed as a partnership. Under IC § 6-3-1-19:

- (a) The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this chapter, a corporation or a trust or an estate. The term also includes a limited liability company that is treated as a partnership for federal income tax purposes.
- (b) The term "partner" means a member of a partnership. (Emphasis added).

Therefore, for purposes of resolving the issue in dispute, the Indiana LLC is properly classified as a "partnership" pursuant to IC § 6-3-1-19. In turn, Taxpayer is a "partner" in an Indiana "partnership." Therefore, Indiana was entitled to hold Taxpayer liable for its own partner tax liability or for its partnerships unfulfilled tax withholding obligation. IC § 6-3-4-13

For each taxable year, the LLC issued Form K-1s to Taxpayer designating the operating income or loss that taxpayer is required to report as attributable to Indiana. For 1998, 1999, 2000, and 2001, the LLC allotted Indiana operating losses to its partners which included Taxpayer. Taxpayer thereafter allotted those operating losses to its nonresident shareholders which the shareholders reported on their individual returns. However, for 2002 and 2003, the LLC allotted operating income to Taxpayer. Taxpayer necessarily maintains that although it was entitled to pass through the operating losses to its shareholders, when the casino business turned profitable during 2002 and 2003, the nature of the operations changed; the 2002 and 2003 operating income became "dividends."

The Department's audit review found that Taxpayer failed to withhold the correct amount of adjusted gross income tax on the operating income - the corporation's undistributed taxable income - credited to its nonresident shareholders. As cited previously, the audit report cited to IC § 6-3-4-13 as authority for doing so. In relevant part, that portion of the law states that:

- (a) Every corporation which is exempt from tax under [IC 6-3](#) pursuant to [IC 6-3-2-2.8](#)(2) shall, at the time that it pays or **credits amounts to any of its nonresident shareholders** as dividends or as their share of the **"corporation's undistributed taxable income,"** withhold the amount prescribed by the department. Such corporation so paying or crediting any nonresident shareholder: (1) shall be liable to the state of Indiana for the payment of the tax required to be withheld under this section and shall not be liable to such shareholder for the amount withheld and paid over in compliance or intended compliance with this section.... (**Emphasis added**).

However, in citing to *Riverboat Development*, Taxpayer implicitly argues that the nature of the income it received was that of an intangible property interest received in the form of dividends. See *Riverboat Development*, 881 N.E.2d at 111 (citing to IC § 23-18-6-2 and IC § 23-18-6-2, "[t]he interest of a member in a limited liability company is personal property... [e]ven more specifically this interest constitutes intangible personal property.")

The Department must disagree with Taxpayer's implicit characterization. For federal purposes, the character of income is determined at its source and is then taxed to each individual recipient. See I.R.C. §§ 702(b), 1366(b). (See IC § 6-3-1-11 specifically incorporating into Indiana law the Internal Revenue Code and Treasury Regulations). The character of Taxpayer's income was determined at the partnership level and the character of

the income necessarily remains unchanged as the income is transferred from one pass-through entity to the next pass-through entity.

At the "partnership level" the income stemmed from the operation of an Indiana casino which was subject to Indiana tax under IC § 6-3-2-2(a)(2). As explained in that portion of the law, "With regard to corporations and nonresident persons, 'adjusted gross income derived from sources within Indiana', for the purposes of this article, shall mean and include: (1) income from real or tangible personal property located in this state; (2) income from doing business in this state...." The nature of the income at issue remained the same as it was passed along from one hand to the next; the income was derived from "doing business in this state" and remained the same even at the point where it crossed the Indiana/Kentucky border. The Department finds no evidence of a transformative event which would anywhere alter the nature of the "income." Further, the Department must take issue with the proposition that Taxpayer received tax-free "dividends" attributable to its membership interest because, of course, the LLC - having elected pass-through - status cannot pay dividends to its members. Only C-corporations and entities having elected to be treated as a C-corporation pay dividends since only those entities have "earnings and profits." See I.R.C. §§ 301, 316.

The notion that Taxpayer has an intangible membership interest in the Indiana LLC is essentially a "red herring" because the Department's concern is not in the intangible membership interest but in the money derived from operating the Indiana casino. Taxpayers intangible membership interest may be bought and sold because it constitutes an enforceable right to a distribution but Taxpayer - as a member of an LLC that elected partnership status for tax treatment - was also allotted a share of the Indiana LLCs casino partnership operating income on which each "partner" was required to pay tax.

The Department finds no substance in Taxpayer's proposition that a nonresident member of an Indiana LLC - an LLC earning income from an Indiana casino - can receive tax-free dividends from the LLC. The analysis is straightforward and seamless: Taxpayer had a "partnership" interest in the operation of an Indiana riverboat. Taxpayers argument to the contrary, the Indiana casino did not earn "dividends" and did not - and could not - pass through dividends to its partners. The nature of the income remained unchanged when the LLC passed the income through to Taxpayer. Therefore, Taxpayer had a responsibility to withhold taxes on behalf of the ultimate recipients if the recipients were not Indiana residents.

Since Taxpayer elected S-Corporation status, Taxpayer does not itself pay tax on the Indiana LLCs casino partnership operating income. Taxpayer as an S-Corporation, credits this operating income to its shareholders for the shareholders to report to Indiana. Under IC § 6-3-7-13, taxpayer is required to withhold tax on the amounts allotted to its non-resident shareholders.

FINDING

Taxpayer's protest is respectfully denied.

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